CHASE

International Finance

Vol. XVII, No. 21
October 25, 1982

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

B1900-1 10/29/82

A Watershed For Fed Policy?

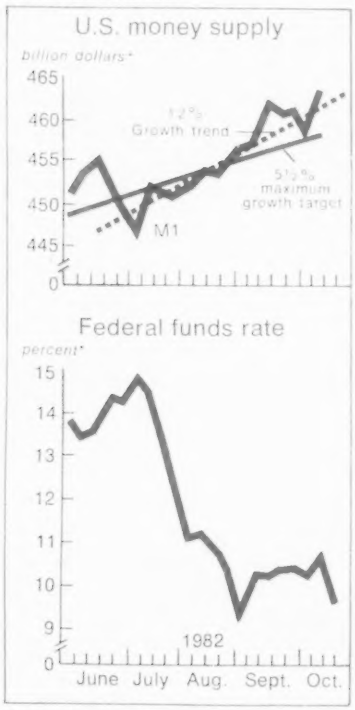
Recent weeks have witnessed an unusual combination of economic events in the United States: a surge in the money supply well above its targeted growth path, a spectacular decline in interest rates, and a rocketing of the Dow Jones Industrial Average through the 1,000 mark. With the economy still mired in a major recession—the unemployment rate is now 10.1% and rising—the rallies in the stock and bond markets may have little to do with any optimism about the prospects for economic growth. Instead, the critical catalyst may have been the turnaround in Federal Reserve policy.

In defending its new posture on policy and the recent monetary bulge, the Fed has declared that inflation has been defeated, implying that the economy can take a strong dose of money without inflation being rekindled. Furthermore, Fed officials have argued that the closely watched M1 concept of the money supply is now so ambiguous that it has become worthless as an indicator of policy. These certainly are plausible rationales. The economy is in recession and inflation has receded dramatically. Moreover, innovations in the financial markets have changed the interpretations that should apply to the various monetary aggregates (although in the past the Fed has managed to cope with this problem by contriving such indices as "M1 Plus" and "Shift-adjusted M1").

A more appropriate justification for a once-and-for-all upward adjustment of the money stock, however, depends on a careful understanding of money demand. Money velocity—the speed at which money is passed from hand to hand—accelerates as inflation increases, since rising inflation penalizes those who hold onto their money. But, as inflation becomes less of a problem, the penalty is reduced. Thus, the velocity of money may temporarily decline or move to a slower growth path. This means that a given level of economic activity needs a one-shot infusion of money to help ease the transition from high and rising to lower and falling inflation. Economists refer to this as a "stock" adjustment, which may differ from the "flow" demand for money that relates to long-run nominal economic growth.

If, on the other hand, the Fed continues to prime the pump beyond year-end, its actions may be interpreted differently. Such a policy would risk re-igniting inflation, and interest rates would be off to the races again. But fortunately, while inflation takes time to stop, it also takes time to start. The message here is that one quarter's money explosion does not establish a trend. It will not be known until next year whether the Fed has been playing politics or acting responsibly.

U.S. money growth and interest rates



*seasonally adjusted

© 1982—Economics Group, The Chase Manhattan Bank, N.A.

Current-account surplus forecast for Canada owing to continued recession.

The Canadian current account in 1982 promises to show a substantial improvement over last year's C$5.33-billion deficit. In the first and second quarters of this year, Canada enjoyed seasonally adjusted current-account surpluses of C$220 million and C$588 million, respectively. The major reason for this good news, however, has been the severity of the Canadian recession: Unemployment stood at 12.2% in both August and September, and the latest available data show that industrial output and new orders to manufacturers fell in July while the inventory-to-shipment ratio rose. As yet there are no signs the economy has begun its recovery, although the recent statistics indicate it has at least bottomed out. Nevertheless, Canada's recovery will probably lag that of the United States. Consequently, 1982 may bring the country its first whole-year current-account surplus since 1973.

Downturn forecast for Switzerland as listlessness pervades economy.

All signs point to a continued slowdown for the Swiss economy. The latest data show that real GDP in the second quarter was 0.4% below the level registered for the same period in 1981. And a number of recent indicators suggest a further weakening of economic activity took place over the summer months: Industrial production fell, unemployment continued to climb while job vacancies collapsed, and import growth remained slack. Consumer demand is still weak and investment outlays have been cut back severely. And now construction—which had been the mainstay of growth in recent years—is also going into decline. There is little prospect the economy will pick up before mid-1983. Business surveys show that orders are falling and stock levels remain well above desired levels. Overall, 1982 real GDP seems likely to decline by around 1.5% following growth of 1.9% in 1981.

Despite economic slump, Belgian government strives to contain budget deficit.

The Belgian economy remains in recession. Official expectations are that real GNP this year will grow 0.5% at best, while inflation is forecast to accelerate to around 9%-10%. At the same time, however, the current-account deficit is expected to fall by some 20% from last year's $5.2 billion shortfall. Despite the continued sluggishness of the economy, the government has proposed a tough 1983 budget: Current expenditures are projected to rise by 7.5%—against an officially projected 1983 inflation rate of 7.6%—and capital spending will be down by almost 4%. The government's net financing requirement is forecast to decline from 12.7% of GNP in 1982 to 10.5% next year, and the gross borrowing requirement (which includes borrowing to repay existing debt) will fall from 16.7% of GNP in 1982 to 15.8% in 1983. As a result, the government projects real GNP will grow by some 1.3% in 1983. But with the German outlook continuing to worsen, even this forecast could prove to be overly optimistic for Belgium's export-dependent economy.

Competitive devaluations among the Nordic countries.

The relative stability that usually characterizes the currencies of Scandinavia and Finland has turned to turmoil over the past few months. In early August, the Norwegian central bank's updating of the weights used to calculate the trade-weighted value of the kroner led to an effective devaluation of that currency by some 3%. On September 6, the kroner was officially devalued by an additional 3%. Exactly one month later, Finland devalued the markka by 4.3%. Then on October 8, after hurried consultations held at Stockholm's International Airport with officials from the other Scandinavian countries, Sweden devalued its krona by a full 16%. This action elicited strong criticism from the Finnish government and a further 6% devaluation of the markka on October 9. The Scandinavian nations and Finland have had above-average inflation rates and some compensating currency devaluations had been expected. Nonetheless, the flurry of downward movements has posed problems. First, it has raised suspicions among the countries—which usually have relatively strong common interests—that these exchange-rate adjustments (plus others that may be still to come) represent unjustified attempts to gain an unfair trading advantage. Second, the changes have left the Danish kroner in an extremely exposed position, already igniting adverse speculation. As a member of the European Monetary System, however, Denmark cannot change its exchange rate without prior discussion with

its EMS partners. Still, because trade with Finland and with the other Scandinavian countries represents such a significant portion of Denmark's total international trade, the other members of the EMS are expected to be tolerant of the Danish quandary. Consequently, over the near term, further speculation on exchange-rate adjustments seems inevitable. The longer-run outlook will depend on whether the adjustments already made will encourage additional steps to help contain inflation and strengthen balance-of-payments positions. Without these improvements, the devaluations will be no more than temporary—if nonetheless expedient—palliatives, and further devaluations can be expected to occur.

Ecuador requests refinancing of public-sector bank debt.

Ecuador has requested the refinancing of $1.22 billion in foreign-bank debt falling due between November 1982 and December 1983. Its total external public debt now stands at $4.68 billion, of which 64% is owed to private banks. The government took the initiative for a number of reasons: Oil export income, which brings in over 60% of total export receipts, has declined 15% this year because of softer prices. Moreover, short-term loans—accounting for some 70% of the $1.22 billion—have created a sharp bulge in the debt profile. And finally, the volume of medium- and long-term external credits available to Latin American countries has been sharply reduced this year because of regional and international debt concerns. Ecuador already has backed its request by eliminating gasoline and wheat subsidies. Efforts are also underway to reduce the public-sector deficit and improve the trade balance. But as the adjustment process unfolds, economic growth is bound to slow.

Japan's stimulatory package unlikely to trigger recovery.

Shortly before the sudden resignation of Japanese Prime Minister Zenko Suzuki, the government adopted a modest 2.07 trillion yen stimulatory package for the second half of the fiscal year ending March 31. The economy had shown surprisingly good growth during the first two quarters of 1982—annual rates of 4% and 5.2%, respectively—thanks to unexpectedly strong consumer spending and the acceleration of public-works investment. But with exports depressed and showing no sign of recovery, consumer spending turning sluggish because of unseasonably cool weather, and large firms beginning to scale back their investment plans because of the poor business outlook, the government felt compelled to act to stem any further economic deterioration. The room for maneuver, however, was severely constrained. A loosening of monetary policy threatened to further weaken the yen, while the adoption of a more stimulative fiscal policy threatened to swell the budget deficit. Suzuki's rather modest measures reflect this dilemma, and the next government will necessarily find itself in the same boat. A little pump-priming may help support the economy at its current level, but it is not likely to lift Japan out of its economic slump.

OPEC's current account headed for 1982 deficit.

The OPEC nations' combined current-account surplus in 1981 narrowed to about $57 billion (after official transfers) from $106 billion in 1980. This sharp contraction occurred despite a 10.5% hike in the average effective OPEC oil price to $34.25 per barrel, and a 19.2% rise in non-oil exports of goods and services to $62 billion. Soft world demand for oil—reflecting economic recession in the West as well as continued energy conservation—caused a drop of 16.4% in OPEC oil output last year to an average of 22.5 mbd, yielding gross oil income of $251 billion. And imports of goods and services as well as transfer payments continued to expand, albeit at a slower pace than previous years, rising 14% to $256 billion. For 1982, the current-account balance is projected to deteriorate much more sharply. OPEC oil production will drop again, averaging about 19 mbd, despite the expected pickup in world demand during the fourth quarter. Moreover, the effective oil price is likely to average $33 per barrel, down almost 4% from 1981, yielding gross oil income of $200 billion. And payments for imports, as well as transfers, are expected to rise by 7% to $274 billion. Even allowing for non-oil exports of $66 billion, OPEC's combined current account looks set to swing into a deficit of about $8 billion.

An Ambiguous Economic Report Card

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data
Argentina	Some economic revival, thanks to low real interest rate policy, but inflation is accelerating	June	4%	178.0	$4,942	June
Barbados	Government adopts IMF plan to reduce fiscal deficit by cutting spending and raising taxes	May	17%	0.8	3,640	Aug.
Bolivia	Civilian government regrets military, facing official period of austerity and large debts	April	10%	4.0	1,082	June
Brazil	Strike bank reserve requirements designed to restrain credit and imports; economy at low level	July	11%	284.8	2,207	July
Chile	IMF credits of $900 million under consideration as international reserves decline	June	7%	19.1	3,329	Aug.
Colombia	New government puts lead on public spending; growth stresses agriculture and construction	May	12%	47.1	1,799	Aug.
Costa Rica	Government considers tax measures as part of IMF stabilization plan to reduce public sector deficit	July	1%	4.2	1,560	Aug.
Dominican Rep.	New president proposes taxes, spending cuts, and wage price freeze as part of austerity plan	July 81	6%	7.3	1,211	Aug.
Ecuador	Government requests commercial banks to extend refinance Nov. 1982 Dec. 1983 public sector debt	April	10%	13.9	1,614	Aug.
Guyana	Economy in difficult straits as foreign exchange scarcity limits key imports; inflation, unemployment up	March	23%	0.5	605	Aug.
Jamaica	IMF providing a record $560 million from various credit facilities to support economic recovery	June	30%	2.9	1,283	Aug.
Mexico	Large debts, foreign exchange woes, low demand and inflation dim business outlook	June	21%	234.1	3,301	Feb.
Panama	Economy slows in response to cuts in public spending; new cross-isthmus pipeline in operation	June	17%	5.8	2,937	July
Paraguay	Construction slowdown expected to push real GDP growth in 1982 down to 4% from 8% in 1981	June	42%	5.5	1,664	Aug.
Peru	Government reduces food subsidies and cuts spending to help bring down inflation	June	17%	21.0	1,360	June
Puerto Rico	Recession still grips economy but July inflation down to 3.2% annual rate; unemployment is high	March	16%	12.7	3,656	March
Uruguay	Loss of international reserves causes contraction of domestic monetary base; IMF talks held	Dec.	7%	10.9	3,711	July 81
Venezuela	Finance minister asks foreign banks to refinance short-term public external debt	June	19%	69.1	4,454	Aug.

The Markets Interpret Fed Behavior

...YMENTS		MONEY AND BANKING							COUNTRIES
...ter... current influences on payments	latest data	12-month changes consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars October 20, 1982	change from year earlier	current monetary conditions	
... trade surplus rises on imports, ex...	June	9%	June	14%	.000037	-70%	Domestic interest rates subsidized.	Argentina
Travel receipts decline sharply.	June	7%	June	9%	.4975	— 4	Public credit restricted.	Barbados
U.S. drug growth 2000 million in cut	May	11%	May	13%	.0057	47	External debt in arrears.	Bolivia
New export incentives imposed.	July	97%	April	74%	.0056	59	Interest costs rising.	Brazil
New crowding and ...ncentives ... [illegible]	Aug.	9%	March	2%	.0152	44	Private external debt flows decline.	Chile
Tax credits ... [illegible]	June	16%	Jan.	21%	.0150	75	Monetary authorities increasing bank supervision.	Colombia
Fuel shortages ... [illegible]	June	4%	Jan.-April	45%	.3735	54	Foreign debt interest is in arrears.	Costa Rica
Import ban ... [illegible]	April	1%	June	9%	Par	—	Ceilings set on interest rates.	Dominican Rep.
Oil export gains ... [illegible]	Aug.	14%	March	27%	.0302	12	Monetary policy is restrained.	Ecuador
Bullish gains ... [illegible]	Jan.	7%	July	71%	.3401	2	External debt being renegotiated.	Guyana
Tourism ... [illegible]	June	7%	June	50%	.5600	0	Public sector credit curtailed.	Jamaica
Government allocates foreign exchange ...	Aug.	19%	June	10%	.0100	75	Credit now available.	Mexico
Canal receipts ... [illegible]	July	5%	May	9%	Par	—	Credit is available.	Panama
Minimum 180-day credit ... [illegible]	Aug.	8%	June	4%	.0079	1	Rediscount facilities reduced.	Paraguay
Oil sales ... [illegible]	July	10%	April	46%	.0014	42%	Central bank curtailing credit.	Peru
July tourism down 21% ... [illegible]	July	3%	March	7%	Par	—	Savings deposits decline.	Puerto Rico
Devaluations ... [illegible]	Feb.	30%	July	0%	.0755	18%	Rise in domestic interest rates.	Uruguay
Central bank boosts level of international reserves.	Aug.	30%	March	5%	.2320	0	Domestic interest rates competitive with world rates.	Venezuela

World Interest Rates

market rates of Oct. 20, 1982; bond yields as of Oct. 15, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	9.50	11.62	9.625 intervention rate	12.00 October 21	9.50	6.00 effective October 22	18.00 penalty rate 21.00	6.50	5.00	5.50
Day-to-Day Money	9.375 October 21	14.75	9.78	10.80	14.00	7.55	18.50	7.125	1.625 1-month Euro-Swiss fr. rate	6.8125
Treasury Bills 91-day, Middle Rates	7.55	11.25	8.9375	12.75	n. a.	n. a.	16.15 71 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	8.78 finance paper discount basis	11.60 finance paper 15% tax w/h	8.78	12.20 Certified	13.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.80	11.50 15% tax w/h	9.00	12.40 Certified	not traded	8.05	19.60	no market	3.375	no market
Government Bonds Long-term, new and old issues, average yield	10.72	12.78	10.18	9.548 20% tax w/h	15.175	8.19	19.32	9.72	4.33	8.18
Industrial Bonds prime, long-term, new and old issues, average yield	12.00 Aa Industrials	14.75	11.79	15.146	16.16	8.24	20.90	10.35	6.09	6.66
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	13.75	9.375	16.25	16.05	11.50	20.75 ⅛ qtrly fee on outstdng	9.00	9.00	6.00
Bank Time Deposits 3-month	8.78 Cert. of Dep.	11.50	9.375	12.70	13.75	7.50	11.50	7.125 large deposits	3.00 residents only	3.75
Eurocurrencies 3-month, asked	9.875	11.875	9.50	no market	21.50	7.00	no market	7.00	3.50	6.9375
Exchange Rates—in U.S.$ rates floating against the $	—	.8150	1.6950	.0204	.1401	.3953	.000693	.3623	.4603	.00368
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.00 *D*	1.00 *D*	3.25 *D*	8.25 *D*	3.00 *P*	10.50 *D*	3.00 *P*	6.50 *P*	3.00 *P*

Eurodollar Deposits
(London, interbank, bid)
October 21

7-day	9.6875
1-month	9.6875
3-month	9.875
6-month	10.125

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−6.402
U.S.-Canada Treasury Bills	−1.243
U.S.-Canada Finance Co. Paper	−0.661
Eurodollars-U.K. Local Auth. Deposits	+1.625

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	11.78
Over 7 yrs.	12.25
DM Bonds	
7 yrs. and under	8.50
Over 7 yrs.	8.50

Gold Price
London afternoon fixing
422.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Aug.) 5.9	(Sept.) 10.4	(Sept.) 7.3	(Sept.) 9.9	(Sept.) 4.9	(Sept.) 17.2	(Sept.) 5.5	(Aug.) 3.1
Industrial production*	(Sept.) −9.7	(July) −14.0	(Aug.) 0.6	(June) −0.8	(Aug.) −3.7	(Aug.) 0	(March) 0	(Aug.) 1.2
Trade balance† *(billions of local currency units)*	(Aug.) −$7.08	(Aug.) C$1.35	(Aug.) −£0.037	(Sept.) −FF12.2	(Aug.) DM2.71	(Aug.) −Lit 1,000	(Sept.) −SF0.88	(Aug.) ¥253.6
Money supply (M1)*	(Sept.) 6.8	(July) 2.5	(July) 11.2	(July) 14.7	(May) 3.7	(May) 8.2	(May) 0.9	(June) 4.7
Velocity of money (M1)*	(June) −0.4	(March) 5.5	(March) −5.3	(Dec.) 0**	(March) 3.1	(March) 0**	n. a.	(June) −1.4
Reserves minus gold *($ million, change from previous month)*	(Aug.) 0	(Aug.) 600	(Aug.) 55	(Aug.) 1,494	(Aug.) −443	(Aug.) 871	(Aug.) 212	(Aug.) 1,199

* Percent change from 12 months earlier. **based on GDP † Figures are only for the month indicated.

Reflation—And a Strong Dollar Ahead?

While economists and government policymakers worry about the current world recession and about the effects of the disinflation process on the international financial system, the stage may be being set for another round of worldwide inflation. Turmoil in the financial markets and the severity of the recession have already given rise to strong pressures for a move to inflationary economic policies in many parts of the world. It is possible that the engine of inflation is already being started. So far, the Federal Reserve seems to have resisted such a shift, despite its recent decision to ignore a rise in its "M1" measure of the money supply above target. And unless it becomes apparent that the Fed has changed course, the dollar will remain strong.

Pressures for a policy shift

Political pressures for the world's central bankers to reflate are clearly intensifying. Basically, they stem from two sources. The severity of the world recession is the major influence. Unemployment is now at 7.5% in West Germany, 8.9% in France, 10.1% in the United States, 11.1% in Belgium, 12.8% in the Netherlands, and 14% in Great Britain. Partly because of this, France has already chosen a reflationary path. And German unemployment—the highest suffered in 30 years—has been repeatedly cited as one of the principal forces underlying the recent fall of Helmut Schmidt's government. Another source of pressure for reflation policies is the fragile state of the world's credit markets. The recession has increased the risks of a severe crisis—admittedly only from "impossible" to "almost impossible." But the difference is significant, as it should be, to the world's central bankers.

The international financial system must now deal with the dangers of both corporate and sovereign default. Many recent corporate investments, which were made in the expectation of continued inflation, are no longer profitable. For example, in 1980, the per-barrel price of oil was widely expected to rise to $55 by late 1984. Drilling and exploration firms, among others, made their planning and investment decisions based on this projection. Today, however, many of the same forecasters are suggesting that $25-per-barrel oil is more likely. Consequently, now that anticipations have changed, investments made under the old expectations must be *repriced*. And this process will inevitably push some firms into bankruptcy. Although oil provides a clear example of how the disinflationary process leads to capital repricing, the same analysis applies to other commodities and capital expenditures made for mines, farm equipment, land, and other purposes.

Also worrisome is the increasing inability of some countries to pay their debts. This has been fostered not only by the world recession and high interest rates, but also by the same repricing problems facing many corporations. High interest rates imply greater strain on the export sector to finance higher interest payments at exactly the same time export demand has fallen. Normally, this would not be a problem, but with many countries' assets being repriced downward, new credit to cover deficits is less available.

Central banks fear that international bank lending, both to corporations and to countries, will contract sharply, possibly owing either to the bankruptcy of a major firm or to default by a large sovereign borrower. The result could be the onset of another and more severe worldwide recession. So the stakes are clearly high, even though the odds of such a sharp loss are still quite low.

The chances of a financial collapse are slight, but these chances are substantial enough that the monetary authorities of the major industrial powers are beginning to take action. They may even over-react. Certainly, one available policy choice—although one that many economists view as incorrect—is to inject massive amounts of liquidity into the world's economic system. This course would simultaneously ameliorate the symptoms of world recession and make it easier for borrowers to meet their obligations, both by easing access to new credit and by generating an inflation that would permit old debts to be paid with depreciating currency.

The impact on the dollar

Theoretically, a world reflation should be neutral for the dollar. However, the U.S. authorities have indicated that the United States may not fully cooperate in a world reflationary scheme. For instance, the American representatives at the September meeting of the International Monetary Fund in Toronto were conspicuously less sympathetic to the plight of the world's borrowers, arguing for much smaller increases in IMF loan quotas than the doubling proposed by some. The United States—or at least the current administration—is philosophically opposed to such rescue operations and more steadfast in its commitment to moderation in the creation of liquidity. And there are also economic reasons to think the United States will find it even easier to maintain a relatively tighter monetary posture in the long run if other industrialized countries now choose to loosen. Those reasons follow from the interrelatedness of the world's monetary regimes.

The dollar is still the world's key currency, but the current restrictive world monetary environment is not the product of Federal Reserve policies alone. It has resulted instead from a sharp fall in the rate of increase

Reflation—And a Strong Dollar Ahead? (continued from page 7)

of the *total* world money supply. While the world money supply is not well-defined, it must include not only dollars, but also West German marks, Japanese yen, and other currencies that are becoming increasingly substitutable in world trade.

As is well known, the availability of substitutes is one important determinant of the demand for any commodity. Money is indeed a commodity, so the availability of foreign monetary substitutes must be regarded as one element determining the demand for dollars. Thus, when domestic and foreign currencies are substitutes, the monetary environment, and therefore economic activity at home, depend in part on the posture of foreign monetary authorities. This is clearly important for small, open economies. But it has recently been shown in the economics literature that changes in velocity—or the rate of turnover of money—in the large, industrialized economies are also associated with changes in foreign money supplies. And it has even been shown that inflation in the United States is better explained by changes in the world money supply, defined as a weighted average of dollars, marks, and yen, than it is by changes in U.S. dollars alone.

U.S. interest rates

Foreign monetary looseness will therefore make tight money a little less confining in the United States. Not only will foreign money serve to increase U.S. economic activity through increased export demand as the foreign economies recover, but foreign relaxation may now provide the impetus for the next fall in U.S. short-term interest rates. This could happen in the following way:

The short-term rate depends on the properties of money and interest-bearing financial instruments. Non-interest-bearing dollars are held instead of interest-earning liquid assets, such as Treasury bills or certificates of deposit, because of the transactions services non-interest-bearing money provides. The benefit of holding money is the transactions services it provides above those provided by "near-monies." The cost of holding money is the nominal interest forgone by not holding interest-bearing assets instead. In the short run—that is, when nominal income can be considered fixed—the short-term interest rate is the relevant price that equates the demand for narrowly defined money with its supply.

The production of more foreign balances in real terms—dollar-real-balance substitutes—reduces the marginal productivity of dollar balances. This means that even if the Federal Reserve maintains its current dollar supply strategy while foreign central banks loosen, the U.S. economy could enjoy lower interest rates with the same relatively tight U.S. monetary policy. Simultaneously in the bond and equity markets the process of adjustment will entail an incipient relative increase in the demand for U.S. dollar-denominated assets. The exchange markets adjust to the new policies as individuals bid up the value of the dollar, just as they bid up the value of dollar-denominated financial assets. Higher exchange rates work back into the U.S. goods markets, bringing lower inflation as greater competition from imports dampens price increases of American-made goods.

As apprehension about the possibility of world reflation grows, the financial markets will respond quickly. In fact, concern about an asymmetric world reflation may explain the current "unexplicable" strength of the dollar.

This theoretical presumption receives some support from world monetary data. The table below compares near-term and longer-run rates of M1 growth for seven major European countries and the United States. The table points to a coordinated pickup in

Changes in M1
(percentage change*)

	Short-term**	12-Month
Belgium	19.4	4.5
France	14.2	14.3
West Germany	7.3	3.2
The Netherlands	37.1	6.2
Switzerland	16.3	3.5
Italy	14.5	7.5
Great Britain	14.3	14.4
United States	3.6	6.8

*period-over-period
**latest available 3-month average, annual rate

the rate of money growth in all those countries where it was not already high. Although recent Fed actions support the view that the United States is in the pact, it is not yet clear if the Fed has changed its basic anti-inflationary policy. America is in a position to stop the money creation process. And as the table shows, despite the rapid money growth in the United States during the last two months, the U.S. money trend has decelerated in marked contrast to most of Europe.

The table may contain the first portents of the next world inflation, an inflation fueled by central bankers' fears of recession and financial collapse. The Federal Reserve may be persuaded to participate, but, at present, it appears that the United States is the most likely of the Western nations to resist the temptation to print money excessively. If this is the case, then the United States might find itself as the possessor of the world's strongest currency, and an isolated island of price stability as the rest of the world becomes more and more dependent on inflationary finance.

Lee R. Thomas
D. Sykes Wilford